DEPARTMENT OF STATE REVENUE

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LETTER OF FINDINGS NUMBER: 95-0620 ST
Sales and Use Tax
For The Period: 1991-1994

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. **Sales/Use Tax -** Software Licensing Agreement

Authority: IC 6-2.5-3-2; IC 6-2.5-4-10; IC 6-8.1-3; Information Bulletin No. 8 issued (Feb. 9, 1990)

The taxpayer protests the imposition of use tax on software licensing agreements.

II. **Tax Administration** - Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of the ten percent (10%) negligence penalty.

STATEMENT OF FACTS

The taxpayer protests the assessment of use tax on licensed and leased software.

ISSUES

I. Sales/Use Tax - Software Licensing Agreements

DISCUSSION

The taxpayer protests the use tax assessed on the licensing (leasing) of computer software. Under IC 6-2.5-3-2 use tax is imposed on the "[s]torage, use, or consumption of tangible personal property in Indiana, if the property was acquired in a retail transaction…" unless an exemption is granted. The taxpayer asserts that it purchased a licensing agreement to use computer software, but did not lease tangible personal property in the form of computer software. Thus, the taxpayer believes there is no basis for imposing use tax. IC 6-2.5-4-10(a) states:

> A person... is a retail merchant making a retail transaction when he rents or leases tangible personal property to another person. In the instant case, a license or lease agreement is tantamount to the renting or leasing of tangible personal property. Although the taxpayer is not acquiring ownership rights to the computer software, it is purchasing the right to use the software for a period of time.

The taxpayer cites the promulgated regulations of the State Board of Tax Commissioners, which state at 50 IAC 4.2-4-3 (g), that application software is nonassessable intangible personal property. The Indiana Code at 6-2.5 does not reference the regulations promulgated by the State Board of Tax Commissioners and instead adheres to Information Bulletin #8 (issued February 9, 1990) which classifies software as tangible personal property.

Also, the taxpayer challenges the validity of Information Bulletin #8 (issued February 9, 1990), stating that it was issued without statutory authority or proof of legislative intent and is non-binding on the Department. However, IC 6-8.1-3, gives primary responsibility to the Department for the administration, collection, and enforcement of the listed taxes. This, by way of necessity, includes the power to interpret the statutes governing the listed taxes. Information Bulletin #8 was administered in a manner that is consistent with the authority granted to the Department. Therefore, the Department recognizes and follows the interpretation contained in Information Bulletin #8. The Department also recognizes that the taxpayer wants to recognize Information Bulletin #8 to the extent it finds the language favorable.

The taxpayer argues that the software at issue is exempt because it was customized for their use and cites Sales and Use Tax Information Bulletin #8, (hereinafter "bulletin") at Section II, part B, paragraph 1, which states the following:

> (t)ransactions involving computer software are not subject to Indiana Sales or Use Tax provided the software is in the form of a custom program specifically designed for the purchaser.

The Bulletin also states:

> Pre-written programs, not specifically designed for one purchaser, developed by the seller for sale or lease on the general market in the form of tangible personal property and sold or leased in the form of tangible personal property are subject to tax irrespective of the fact that the program may require some modification for a purchaser's particular computer. Pre-written or canned computer programs are taxable because the intellectual property contained in the canned program is no different than the intellectual property in a videotape or a textbook.

Under these two provisions, the taxpayer argues that its computer software purchases are not subject to sales and use

tax because the software is customized and modified to the needs of its company. The taxpayer asserts that the software is a "shell" with little or no practical use before modification. In addition, the taxpayer asserts that it spends two to three times the shell price in assessing its use for the software and actually having the vendor company modify the software to fit its needs. Simply based on the quantity of time spent assessing and modifying, the modifications are "significant." Thus, the taxpayer argues that the software is a non-taxable "custom program" within the meaning of the bulletin.

The taxpayer's software, however, fails to meet the custom design exemption. As stated before, the Information Bulletin describes canned software as pre-written programs not specifically designed for *one* purchaser and developed for sale or lease on the general market. (Emphasis in original) In this situation, the software was a pre-written program, not specifically designed for one purchaser, and developed by the seller for sale or lease on the general industry market. Based on these facts, the base (shell) is the same as (canned software) and is tangible personal property.

FINDING

The taxpayer's protest is denied. The leasing of canned software is subject to the use tax.

II. **Tax Administration** - Penalty

DISCUSSION

Taxpayer protests the imposition of the ten percent (10%) negligence penalty. The negligence penalty imposed under I.C. 6-8.1-10-2.1 may be waived by the Department where reasonable cause for the deficiency has been shown by the taxpayer. Specifically:

The department shall waive the negligence penalty imposed under I.C. 6-8.1-10-2 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. 45 IAC 15-11-2(e).

The taxpayer believed that the software was customized because of the modifications made to the original product. The taxpayer read Information Bulletin #8 and believed that it was entitled to the exemption for custom software because of the modifications. Due to these circumstances, the taxpayer has established reasonable cause for its interpretation of the law. The taxpayer's protest is sustained as to this issue.

FINDING

The taxpayer's protest is sustained. The ten percent (10%) negligence penalty will be waived.